

Pay Me Now: Understanding Contingent Payment Provisions

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As every experienced general contractor and subcontractor knows, getting paid for your work is sometimes more difficult than the work you were contracted to perform. Part of this difficulty can result from the detailed payment terms in the project's contract. These payment terms take on increased importance in complex projects with several layers of agreements involving the owner, general contractor, subcontractors, second tier subcontractors, suppliers and so on.

In these projects with multiple layers of agreements, if the owner refuses to pay, then everyone "downstream" from the initial refused payment often finds that their pay has been shut off. This result tends to occur because the general contractor had planned to pay those downstream workers with funds from the owner, and, in fact, the general contractor's decision not to pay is often authorized by provisions in the project's contract known as contingent payment clauses.

Contingent Payment Clauses

Two of the most common types of contingent payment clauses are "pay-if-paid" and "pay-when-paid" clauses. While these two types of clauses are similar, there is an important distinction between the two. A pay-if-paid clause is a risk shifting device that makes a general contractor's obligation to pay its subcontractor a conditional obligation. To put it plainly, the impact of a pay-if-paid clause is, "if I don't get paid, then I have no obligation to pay you for the work you performed." This

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type of clause effectively shifts the risk of owner nonpayment from the general contractor to the subcontractors and suppliers on the job because, if the owner refuses to make a payment, the general contractor isn't obligated to make a payment, and, instead, the subcontractors and suppliers are the ones left unpaid for work performed and materials provided.

The other most common contingent payment clause is a pay-when-paid clause. A pay-when-paid clause requires only that a general contractor pay its subcontractor within a specified number of days after the general contractor has received payment from the owner. Courts that have analyzed pay-when-paid clauses have held that these clauses create only a payment timing mechanism. Unlike a pay-if-paid clause, a pay-when-paid clause does not allow a general contractor to avoid paying its subcontractors simply because the project's owner hasn't paid the general contractor. Rather, a pay-when-paid clause still requires a general contractor to pay its subcontractors and suppliers, even if the general contractor never receives payment from the owner. The risk of owner nonpayment falls squarely on the shoulders of the general contractor and, in the event of owner nonpayment, it is the general contractor who must decide between paying its subcontractors out of the general contractor's own pocket or breaching its contracts with the subcontractors.

Enforceability

The inclusion of contingent payment provisions in construction contracts can result in subcontractors bearing more risk than they anticipated and, as a result, some states have refused to enforce these provisions exactly as written. In many states, whether a particular provision is interpreted by a court as a pay-if-paid clause or a pay-when-paid clause depends on a specific list of criteria, or the state may flat-out refuse to enforce a pay-if-paid clause. For example, pay-if-paid clauses and pay-when-paid clauses appear to be enforceable in both Iowa and Nebraska as neither the courts or legislatures in these states have ruled otherwise. However, if your contract is governed by the law of a nearby state, be aware, because in Kansas, Illinois, and Indiana pay-if-paid clauses are not enforceable in all situations. As a result, it is important for both general contractors and subcontractors alike to be on the lookout for contingent payment provisions and know that the provisions may not be enforceable in a particular state.

Conclusion

The stark contrast between how courts apply, or refuse to apply, contingent payment provisions underscores why it is important to have an experienced construction attorney analyze the enforceability of contingent payment provisions in light of the specific state law governing the contract in dispute. If you have questions about the enforceability of a contingent payment provision in any of your contracts, please contact a member of the Koley Jessen Construction Practice Group.